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M&G INVESTMENTS

Comparing the investment cases for European and US leveraged loans

October 2019

From the Leveraged Finance Fund management desk

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Executive summary

Leveraged loans, often referred to as bank loans, offer investors a broad and relatively liquid market of private, sub-investment grade loans that can deliver attractive returns with lower volatility when compared with similarly-rated, unsecured corporate bonds.

The investment opportunity set is global, but it is important that investors understand the differences between the two loan markets of the US and Europe, and what it takes to invest successfully in each. While the US loan market is public, larger and more liquid, being well-established over several decades with non-bank investors, institutional investors have steadily recognised the compelling benefits of allocating to European leveraged loans too, as part of a wider fixed income allocation and/or as a complementary adjunct to private credit. Furthermore, there remains significant scope for increased institutional investment in European loans.

This paper looks at the investment benefits of the loan asset class as a whole, the key characteristics of the markets in Europe and the US, and why it may make sense for institutional investors to consider European loans particularly within the context of a diversified investment portfolio.

M&G and European leveraged loans

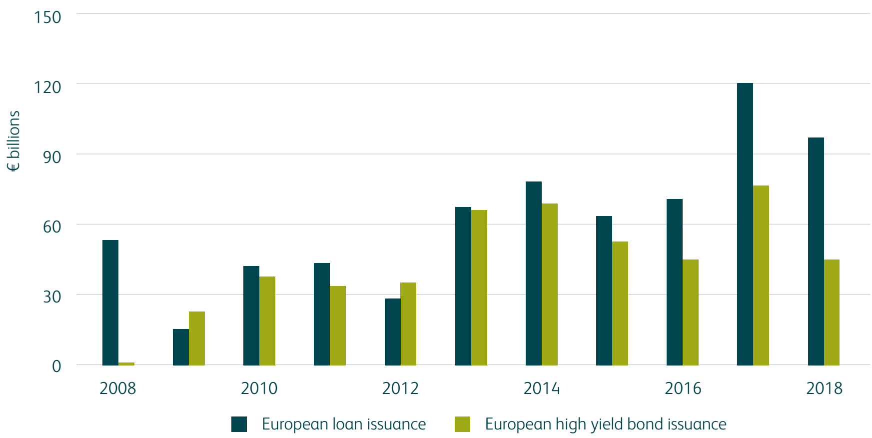
M&G was one of the first non-bank investors in the European leveraged loan market, in 1999, and is one of the largest loan managers in Europe today. Approximately €9.7 billion ($10.5 billion)[1] is managed on behalf of institutional investors across a range of funds in both segregated and pooled form, the vast majority being for pension funds and insurance companies from Europe and Asia.

Introduction to leveraged loans

Rising demand from non-bank, institutional investors

Over the past two decades in Europe (and over four decades in the US), non-bank, institutional investors have expanded their participation in corners of the corporate financing market traditionally dominated by banks. Attracted by the significantly higher returns on offer, institutional investors have taken advantage of the financing opportunities in Europe and the US as banks have scaled back their corporate lending activities to meet stringent capital requirements imposed by regulators, following the global financial crisis.

Figure 1: Annual European loan and high yield bond market supply

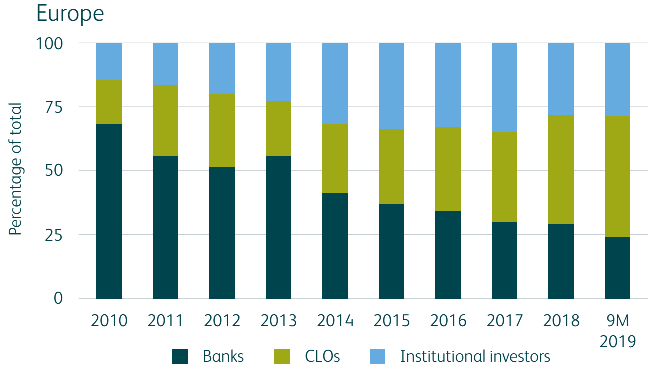


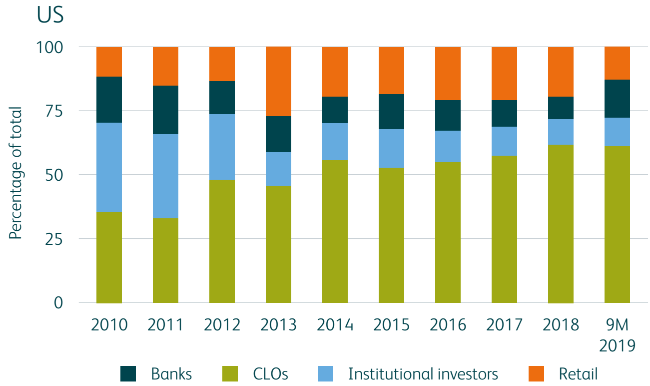
Source: S&P LCD, Credit Suisse, as at 31 December 2018.

[1] Source: M&G, as at 30 September 2019. US dollar figure converted using a EUR/USD exchange rate of 1.088 (ECB official reference rate).

While this resulted in bumper issuance volumes in corporate high yield bonds from 2013 onwards, actually the more important and sizeable part of the momentum has occurred in the European leveraged loans market. Institutional investors, insurers, pension schemes, collateralised loan obligations (CLOs) and banks, make up the lion's share of today's buying base, as can be seen in Figure 2.

Figure 2: The composition of the European and US primary loan markets (% of total)



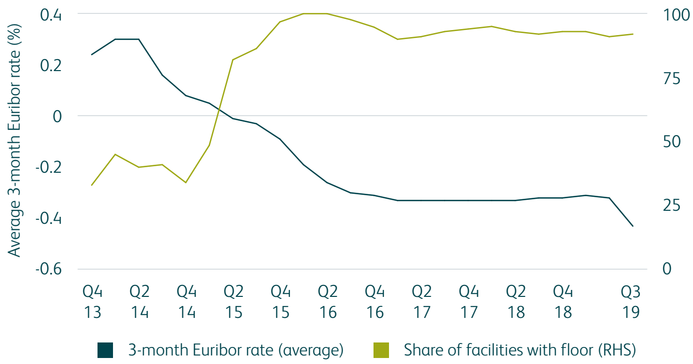


Source: S&P LCD, as at 30 September 2019.

Europe's split is subtly different to that of the US and it is worth understanding the significance of that. In Europe, unlike the US, there are no Retail funds, loans being ineligible assets for UCITS funds[2]. That said, even in the US, the Retail presence is now modest (circa 15%) albeit that it is daily-dealing and includes some exchange-traded funds. The presence of such investors can affect sentiment and exacerbate volatility. Furthermore, in Europe, banks still account for a meaningful – if minority – portion of the term loan market. The presence of banks is helpful in preserving rigour in resisting excessive leverage. Lastly, CLOs are less dominant in Europe, meaning that there is a greater diversity of institutional investor make-up.

Interest rates may be falling and even negative in Europe, but one important aspect of a loan is the worth of its rate-fixing floor. Inherent in almost every Euro-denominated loan is a zero minimum fixing-rate. With money market rates in negative territory, this represents a yield pick-up of c. 50 basis points (bps). This yield support coupled with strategically-allocated institutional capital plus buy-and-hold banks conspire to reduce the relative volatility of the European loan market.

Figure 3: EURIBOR floor analysis*



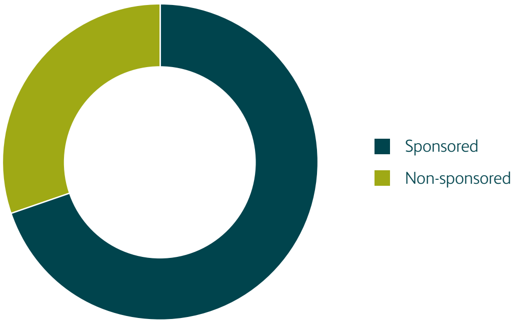
Source: Bloomberg, S&P LCD, as at 30 September 2019. *Includes deals with 0% floor. In 2016, LCD adjusted its calculation of EURIBOR floor benefit to account for zero floor transactions.

In Europe, around 70% of leveraged loan issuance derives from private equity buyout activity, often following large mergers between public companies, which may subsequently divest non-core divisions, perhaps for regulatory reasons. Alternatively, listed companies may offload 'non-core' assets in order to appease their shareholders and boost their valuation multiples. Private equity houses step in to buy these divested entities and come to the leveraged loan market for debt funding. An arranging or lead bank will typically sell such loans, through a syndication process, to institutional investors alongside other banks.

[2] UCITS, which stands for 'undertakings for collective investment in transferable securities' are regulated collective investment funds that can be sold to the general public throughout the EU.

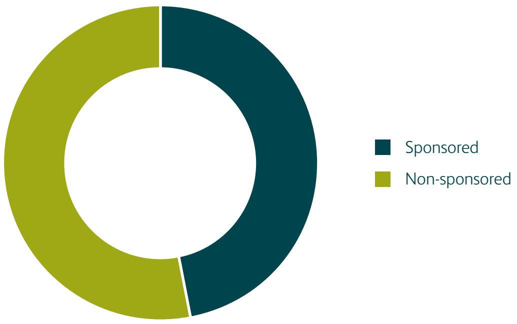
Figure 4: Europe and US sponsored versus non-sponsored loans (based on volume), Jan-Sep 2019

Europe



Source: S&P LCD, as at 30 September 2019. "Sponsored" includes all sponsor-related activity, including buyouts, refinancings and recapitalisations.

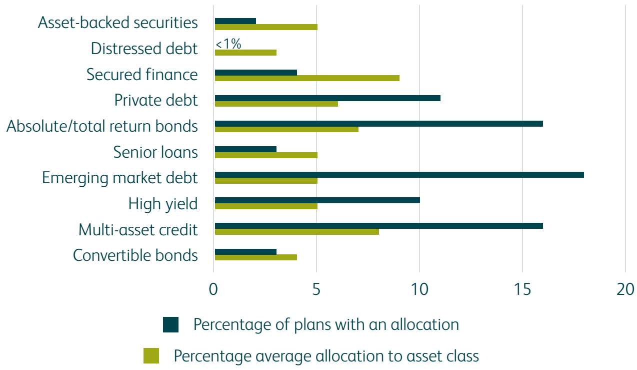
US



Source: S&P LCD, as at 30 September 2019. "Sponsored" refers to total new-issue US sponsored loan volume as a proportion of total loan volume for the period Jan-Sep 2019.

The low interest rate environment has posed a number of challenges for institutional investors, such as pension funds and insurers who can find themselves struggling to generate the investment returns needed to meet their funding commitments or drive profitability. This is particularly pronounced in Europe which accounts for near 50% of the world's US $17 trillion of negative-yielding debt. Consequently, the allocation to leveraged loans and private debt is becoming more common. According to Mercer, for those investors, 5% of their 'return-seeking', growth-orientated Fixed Income allocation is typically allotted to loans.

Figure 5: UK and European pension plans' strategic allocation to 'growth-oriented' fixed income



Source: Mercer Asset Allocation Survey 2019.

The search for yield has undeniably been one of the main drivers of increased interest in the asset class, while institutional investors have recognised the benefits of making a strategic allocation to leveraged loans as part of a wider fixed income portfolio. This can be achieved through a shift of allocation from high yield bonds to loans (both are sources of sub-investment grade corporate debt), or from traditional investment-grade fixed income investments.

Key features of leveraged loans

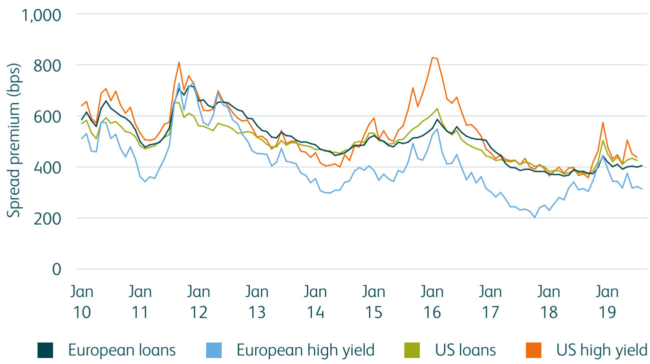
We outline the key features of leveraged loans and explain why investing in the asset class could offer a number of advantages.

The term 'leveraged loans', or 'bank loans', describes floating-rate debt issued – on a secured basis – by sub-investment grade companies, typically to finance mergers and acquisitions (M&A) or leveraged buyouts (LBOs) by private equity sponsor companies.

Strong relative value

When looking at the relative value of loans compared to other asset classes, there appears to be a lot of opportunity. The spread premium of European leveraged loans versus (largely unsecured) corporate high yield bonds has been consistently positive since the financial crisis, with loan spreads around 71 bps wider at the end of July 2019 – helping to underscore the case for an allocation to loans (see Figure 6). US loan spreads, in contrast, have traditionally traded inside high yield bond spreads – although the spread premium for bonds has fallen back in recent years.

Figure 6: Spread premium of leveraged loans to high yield corporate bonds



Source: M&G, Credit Suisse European loan (CS WELLI four-year discount margin) hedged to Euros, US loan (CS LLI four-year discount margin) and US high yield index, Bloomberg (BofAML European HPIC high yield index asset swap spread), CS Research & Analytics, as at 31 July 2019.

Low interest rate duration

Investors may also view loans as a means of capturing high yields while reducing overall duration in a blended credit portfolio. This is owing to their floating-rate structure which creates an interest rate duration of c. 0.15 years and a spread duration of under five years.

End of Libor

Regulators are working on the transition of loans from Libor as base fixing-rate to a new risk-free rate across sterling, US dollars, yen and swiss francs and reformulating its construction in the case of euros.

It is important for investors to understand how leveraged loans can behave in different interest rate regimes. In an environment of low and flat yields, leveraged loans can offer a compelling investment opportunity due to their high running income (enhanced in European loans by the presence of zero floors), low duration and less correlated, sustainable returns. Leveraged loans can also protect investors against the impact of rising interest rates as loan coupons have the ability to adjust higher, based on underlying changes in the short-term reference rate, typically resetting every three months (90 days).

Loans therefore pose minimal interest rate risk to a portfolio and are designed to benefit in a scenario of rising interest rates[3]. High yield corporate bonds, in comparison, typically pay a fixed-rate cash coupon – so income and returns will be susceptible to interest rate changes.

Other defensive characteristics

As leveraged loans can play a number of different roles in a portfolio, there will be different structural and market features that appeal to long-term investors depending on their investment objectives. Together with seniority and security, loans tend to incorporate additional features that can provide comprehensive credit risk protection for an investor.

Importantly, leveraged loans benefit from security over assets and/or equity of the issuing companies, as well as seniority in the capital structure. This means that if an investment does not perform as expected or a borrower defaults, senior lenders receive repayment ahead of junior creditors, thereby affording more downside protection compared to other similarly-rated fixed income instruments. This contributes to the relative stability of loan pricing in the secondary market.

Historically, senior secured leveraged loans have had much higher recoveries than unsecured high yield bonds in the event of default or restructuring, limiting their downside risk. According to data from Moody's Investors Service[4] (measured based on ultimate recoveries), annual recovery rates for senior secured (first lien) loans have been consistently above unsecured global corporate high yield bonds, averaging 80% versus 48% over the period from 1987 to 2018.

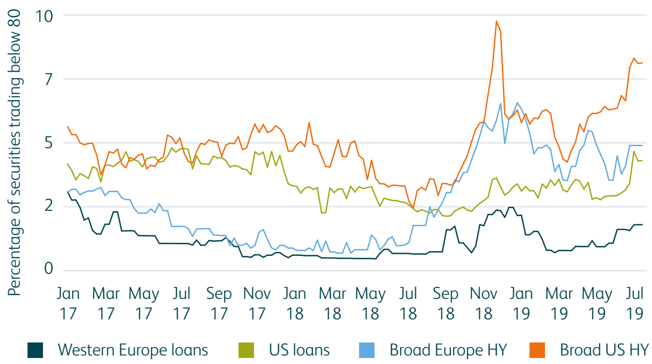
[3] When a loan has a floor, the loan's coupon will reset to the higher of the floor or Libor/Euribor, typically every 30, 60 or 90 days.
[4] Moody's Investors Service 'Corporate Default and Recovery Rates – 1920-2018', February 2019.

Loan documentation for leveraged loan transactions includes contractually-agreed financial covenants, albeit usually on an incurrence basis (to govern the addition of new debt) but sometimes on a maintenance basis (where pro-active demonstration of compliance is imposed on the borrower at regular intervals through the loan's life).

As things stand today, lenders do not need to take on undue risk, on behalf of underlying investors, to get well rewarded. The leveraged loan markets give investors exposure to strong businesses with healthy cashflows spanning a diverse range of industries – the diversification and heterogenous nature of many LBO credits is therefore a defensive feature.

Idiosyncratic risk has been rising across the corporate credit markets generally, but loan default rates in Europe and the US are extraordinarily low – far below the historical long-term average for the market. The level of stress as a predictor of future defaults is also at an all-time low in Europe, with the percentage of loans trading below 80 currently below 2% of the overall index. Nevertheless, careful lending practices, rigorous due diligence and ongoing investment monitoring can help to further reduce a portfolio's default rate.

Figure 7: US and European distress ratios both rising



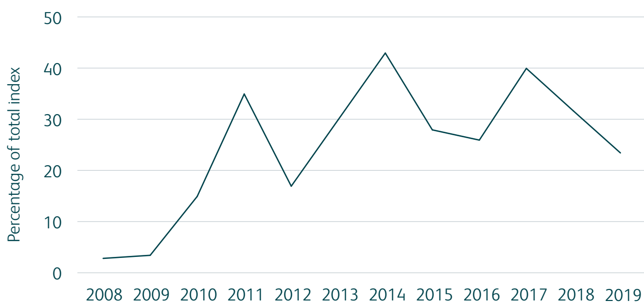
Source: Credit Suisse, as at 31 August 2019. % of securities trading at a price below 80.

Explained: Prepayment feature

Unlike high yield bonds, leveraged loans do not typically have the potential for significant capital appreciation as loans are repayable at par (or face value), so do not tend to trade significantly above this level. This feature gives the borrower the option of early repayment (or the obligation to repay should ownership of the company change), provided it can generate the cash to repay the principal. By contrast, while the majority of high yield bonds are callable, borrowers must observe a non-callable period of several years. Also, for investors particularly concerned about liquidity, there is considerable inherent cash generation in a loan portfolio from this prepayment feature in addition to the presence of a functioning secondary market.

The prepayment rate for European loans, based on a medium-term average, is c.25% per annum.

Figure 8: European loan market repayment rate (% of total) per annum



Source: S&P LCD European Leveraged Loan Index (ELLI), as at 31 July 2019.

The European and US leveraged loan markets compared

The global loan market is made up of two distinct main markets: Europe and the US, and both have been present in non-bank investment portfolios for over two decades. Investor participation in the US predates that of Europe, that market's inception being 1986, making it some ten years older than Europe and Retail investor presence, while lacking from the European market, has been a long-standing feature across the Atlantic. The pace and extent of regulatory change has certainly helped to shape the development of both loan markets in the years following the global financial crisis. The US market is overseen by the Securities and Exchange Commission (SEC), while the European loan market is an unregulated one, making it relatively inaccessible to Retail investors. The regulatory authorities are nevertheless well aware of the features of the European loan market, and are turning their attention to identifying who is lending.

The European Securities and Markets Authority (ESMA), an independent EU authority that contributes to safeguarding the stability of the EU's financial markets, acknowledged in a recent report that it is crucial to actively monitor the leveraged loan and CLO markets' developments but adds that European fund exposures to leveraged loans and CLOs appear relatively limited. ESMA also notes that Alternative Investment Funds (AIFs) with large leveraged loans and CLO exposures use limited leverage and do not face a significant liquidity mismatch, with the exception of a few AIFs offering daily liquidity to investors[5]. With the Financial Stability Board (FSB), the global regulator, conducting a review into parts of the global leveraged loan market and Japan's Financial Services Agency (FSA) surveying the nation's financial firms to determine their exposure to CLOs and leveraged loans too, regulatory oversight of the loan market is certainly increasing.

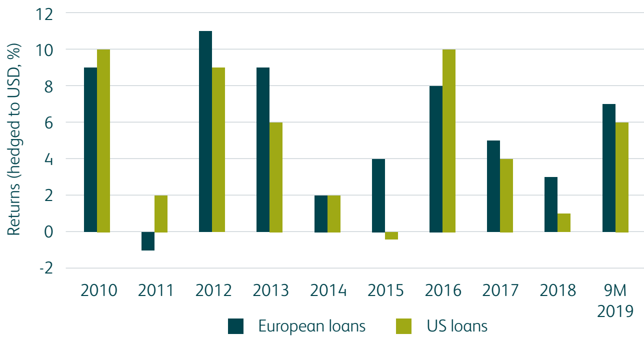
The investment opportunity set is global, but there are significant regional differences that investors should be aware of before investment, which we will explore in greater depth in the next sections.

Long-term performance

Although annual returns from the European and US loan markets look broadly similar over the long term, as shown in Figure 9, European loan returns have traditionally exceeded those of the US, having delivered a premium over the past three, five and ten-year horizons (on an annualised basis).

The European loan market's 2018 total return looks impressive compared to the return generated by the US loan market, however in relative terms, 2015 was the standout year for the European market compared to the US. This was largely down to a wave of defaults in the US market, linked to that market's greater oil and gas exposures. Europe, by contrast, has little representation from these cyclical sectors, being a market more commonly populated by private equity-owned, cashflow-driven companies. Then again, in the year of crisis for the Southern European economies (2011), the US market outperformed Europe.

Figure 9: European and US loan market annual returns – European loan returns traditionally exceed those of the US



	European loan index*	US loan index	Differential
Last three years total return (annualised)	5.69%	4.68%	101 bps
Last five years total return (annualised)	5.34%	4.11%	123 bps
Last 10 years total return (annualised)	6.17%	5.38%	79 bps

Source: Credit Suisse, as at 30 September 2019. *Hedged to US dollar.

[5] Source: ESMA, "ESMA Report on Trends, Risks and Vulnerabilities", No.2, 2019, page 57, published 10 September 2019.

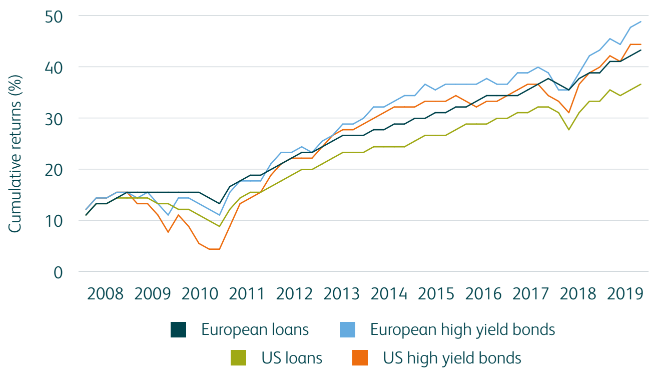
Relative stability of returns

The sectoral distribution of the European loan market, which is biased towards companies with solid operating performance and stable cashflows as befits those owned by sponsors, could also help to explain the relative stability of returns compared to US loans, and equally to US (and European) high yield bonds.

2018 was a standout year for European loans among a landscape of risk assets that were broadly and comprehensively negative, particularly when comparing the performance of European loans to the most directly equivalent sub-investment-grade markets (in euros). In complete contrast to the previous year, 2018 saw a return to volatility, but loans managed to hold out against wider market disruption (albeit not completely immune) thanks to pricing stability and high running coupon income.

The most significant period of post-crisis volatility was in 2011 – at the height of European sovereign debt worries – when loan prices fell five points. The September 2015 wobble in European high yield was not seen in loans and, when fears of Chinese growth contraction and falling oil prices unsettled comparable credit markets at the start of 2016, the European leveraged loan market largely held firm. Even the unexpected Brexit vote in June 2016 and the subsequent political 'shock' of Donald Trump's US Presidential election win later that year, had little impact on cumulative European loan returns, as may be seen in Figure 10.

Figure 10: European and US loan, European and US high yield bond cumulative returns – European loan market has remained resilient during intervening periods of market turbulence



Source: Credit Suisse European, US Loan and European High Yield bond indices (HPIC), US HY (H0A0), hedged to US dollar (USD) cumulative returns, as at 31 July 2019.

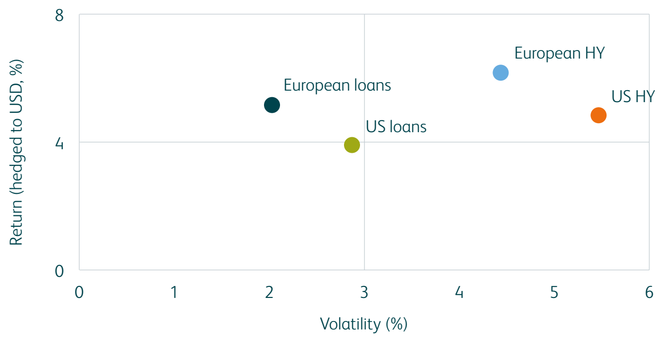
Relatively speaking, investors may be better off looking to 'time' high yield markets, with loan returns tending to be more consistent and less susceptible to wider market moves.

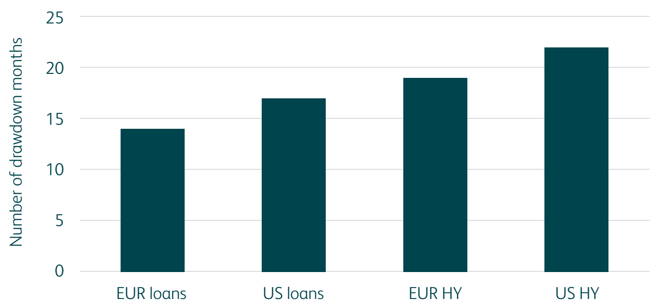
In the periods of macro volatility since the crisis, the loan market has responded but in relatively muted fashion thanks to the characteristics of the asset class as previously described (floating-rate returns, senior secured status), with the protective structural market barriers, specific to the European market, insulating it still further.

Risk-return profile

European loans, in particular, should be noted for their high running income and relatively stable returns. As Figure 11 shows, European loans have exhibited a better risk-return trade-off compared to US loans (and high yield bonds) over a longer time horizon.

Figure 11: Reward for risk (5 years annualised, first graph) and drawdown months (last 5 years, second graph) – European loans offer high and stable risk-adjusted returns over time





Source: M&G, Bloomberg, HPIC, H0A0, Credit Suisse WELLI and Credit Suisse US Index returns all hedged to US dollar, as at 31 August 2019.

The high return correlation between loans and high yield bonds should also be noted here, with this being the more apparent for US loans and high yield bonds compared to Europe over a five-year horizon, as can be seen in Table 1.

Table 1: Monthly correlations between loans and high yield bond returns* (last 5 years)

	US high yield index	Euro high yield index	Global high yield index	European loans	US loans
US high yield index		0.83	0.98	0.49	0.82
Euro high yield index	0.83		0.89	0.58	0.67
Global high yield index	0.98	0.89		0.50	0.79
European loans	0.49	0.58	0.50		0.65
US loans	0.82	0.67	0.79	0.65	

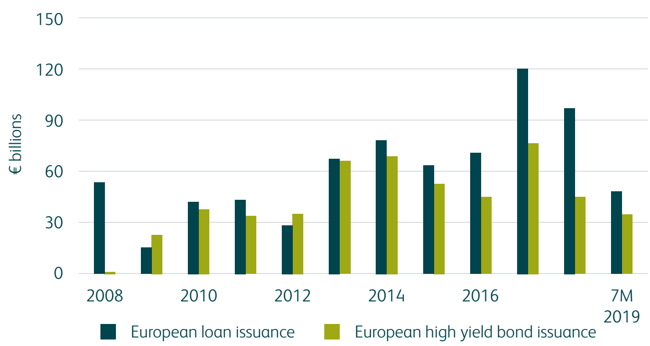
Source: S&P LCD European and US loan indices, ICE BofAML US, European, Global High Yield bond indices, as at 31 July 2019. *Total returns hedged to Euros.

Market size and growth

The Credit Suisse Western European Leveraged Loan Index (CS WELLI), which represents some of the institutional subset, puts the size of the market at €286 billion ($323 billion)[6]. For the US, the Credit Suisse Leveraged Loan Index (CS LLI) is approximately $1.24 trillion[6] in size. However, not everything is captured by the indices, this being a private market, with both markets at least 30% larger, in our view.

Annual issuance of both loan markets since the global financial crisis – set against high yield bond issuance volumes for comparison – can be seen in Figures 12 and 13, respectively.

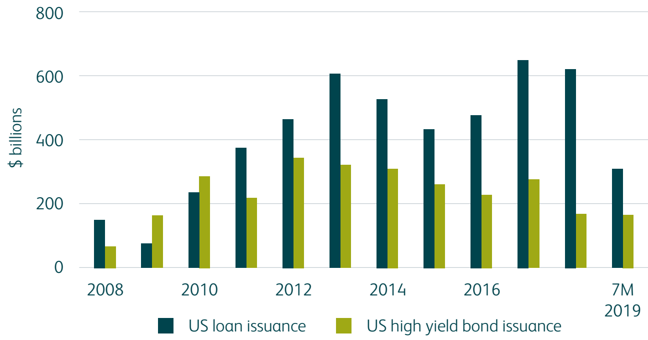
Figure 12: European loan and high yield bond issuance (€ billion) – comparable loan and bond issuance seen post-crisis



Source: S&P LCD, Credit Suisse, as at 31 July 2019.

[6] Credit Suisse, as at 31 July 2019.

Figure 13: US loan and high yield bond issuance ($ billion) – loan issuance has consistently exceeded bond issuance since 2011



Source: S&P LCD, Credit Suisse, as at 31 July 2019.

In M&G's estimation, the addressable loan market in Europe for an established manager is approximately €350 billion ($381 billion). The growth of the European and US loan markets is not as 'explosive' as is claimed and both markets are similar in size to their comparable high yield corporate bond markets, respectively.

We have summarised the key characteristics of the two loan markets in Table 2.

Table 2: European and US loan market comparison – key characteristics at a glance

	European loans	US loans
Institutional loan market size	€350 billion	$1,200 billion
Investors	Banks and institutional investors	(Limited) banks, institutional and retail investors
New issue volume 2018	€97 billion	$621 billion
Nominal spread	349 bps	352 bps
4-year discount margin	401 bps	427 bps
Volatility (5 years)	2.00%	2.86%
Liquidity (average turnover)	c.40%	60%
Loan issues with public ratings	c.80%	100%

Source: Market estimates, S&P LCD, Credit Suisse, as at 31 July 2019.

Investor base and demand for loans

As Table 2 shows, the historical volatility of the two loan markets over the past five years has been broadly similar, although the daily-dealing, Retail investor presence in the US market could help to explain the higher standard deviation of returns relative to Europe, which has no Retail fund community as loans are not classed as UCITS-eligible assets. This could put the European market in sharp contrast to the US, where fund inflows may pressurise spreads to a greater degree if not matched by issuance.

Open-ended funds are now relatively common in Europe albeit that dealing frequencies will typically be monthly, rather than daily, given their institutional nature and the non-standard – and sometimes lengthy – periods for loans to settle. Closed-ended, structured funds, primarily CLOs, account for a sizeable market share in Europe too. This captive European loan investor has continued to support the market and create stability in the investor base, with €27 billion in CLO issuance raised in 2018 and with 2019 on track to exceed that volume.

It is estimated that the CLO share of the European market is c. 40%, meaning that the remaining institutional share – once the c.25% bank-share is accounted for – must be c. 35%, consisting of loan funds, separately managed accounts (SMAs) and some institutional multi-asset credit funds. This is a more balanced composition than the US loan market, where CLOs have an increasingly dominant role (c. 70% share), with daily-dealing retail funds and SMAs making up most of the difference.

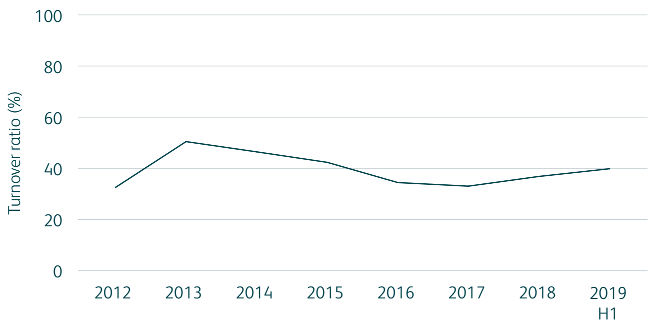
Liquidity: Secondary market volumes

The European loan market has been reasonably liquid since the investor base began to diversify 15 years ago, and thanks to the ongoing maturity of the investor base, now including plenty of non-CLO, long-term institutional capital, the liquidity situation for loans has arguably improved. While less liquid than that of the US, the European loan market is reasonably active in two-way trading, with annual secondary trading turnover ratios for both markets shown in Figure 14. The turnover ratio in the European secondary market is around 40%, while the average turnover of the US market is around 60%.

Lower turnover typically translates into greater market stability, which can be attributed to the absence of daily-dealing Retail funds in the market (that tend to have shorter investment horizons). That said, the long lead-time for settlement of European loans (c. T+30-40 days) – near double that of the US – should still be highlighted.

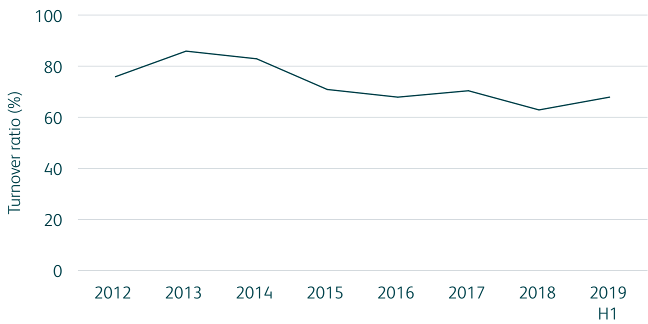
Figure 14: European and US secondary loan market liquidity – turnover ratio (%)

Europe



Source: Refinitiv, as at 30 June 2019.

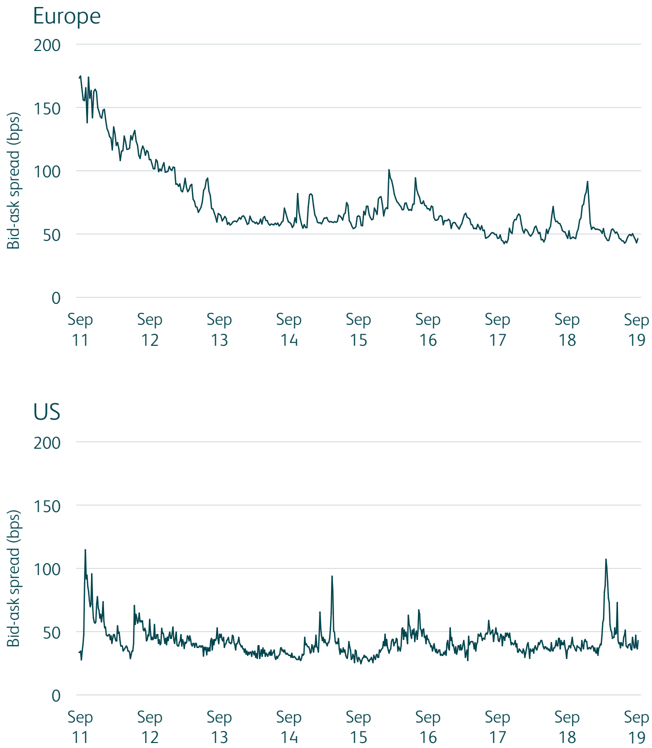
US



Source: LSTA Secondary Trading & Settlement August 2019, as at 30 June 2019.

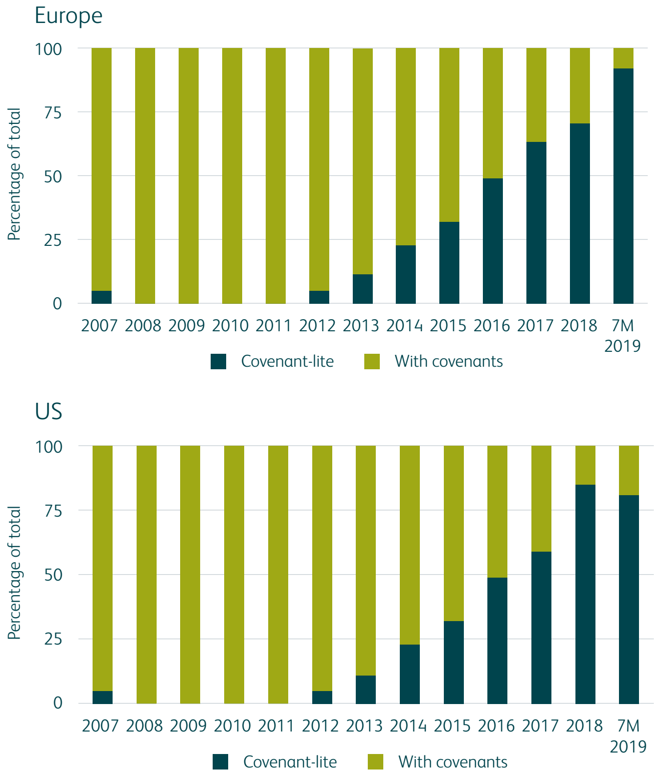
Bid-ask spreads in Europe have tended to be slightly wider than the US, but spreads have narrowed over recent years and the most liquid loans have continued to trade at bid-ask spreads closer to 50 bps since the start of 2013, as shown in Figure 15.

Figure 15: Europe and US flow names composite: bid-ask spreads (bps)



Source: S&P LCD, as at 26 September 2019.

Figure 16: Covenant-lite issuance in Europe and the US



Source: S&P LCD, as at 31 July 2019. Institutional covenant-lite volume as a % of total issuance.

Structures: Leverage and covenants

The US and European leveraged loan markets are now largely covenant light (cov-lite), however, 'cov-lite' does not mean that there are no covenants within a loan's documentation. Even the largest loan's terms will restrict disposals, dividends and make prescriptions regarding information disclosure. In addition to the conversion from maintenance to incurrence covenants, attempts by private equity sponsors, underwriting banks and law firms further, and excessively, to weaken documentary protections have not gone unnoticed by lenders.

According to documentation scores calculated by Covenant Review, European loans have consistently offered greater protection to lenders compared to US loans (composite and LBO-sponsored deals). The research company bases this on the rolling three-month average for new-issue documentation scores for both markets and attributes the difference to several factors including the fact that "European loans have tighter baskets that limit issuers' capacity to make restricted payments, issue new debt in unrestricted subsidiaries". While the use of so-called 'add-backs' to earnings before interest, taxes, depreciation and

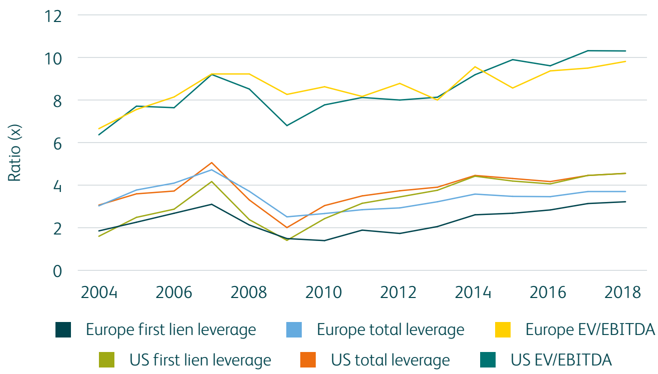
CLO risk monitoring and regulation

CLO portfolios are subject to credit quality tests, imposed by rating agencies. Under regulatory scrutiny, investors' monitoring practices have recently been raised. US CLOs have been excluded from the remit of the Dodd-Frank Act, thanks to a successful lawsuit, in 2018, removing the need for a 5% risk-retention stake in all vehicles to be held by managers. This check remains in force in Europe, however, and may prove to preserve greater credit standards. Furthermore, the European CLO market now falls under the aegis of the 'Simple, Transparent and Standardised' (STS) regulation of the EU. Similar rules are being imposed by the Japanese regulator, the FSA, to ensure adequate assessment by CLO investors of underlying loan collateral. In the case of CLOs without risk retention, greater care is required.

amortisation (EBITDA) – the addition to earnings of non-recurring expenses, for example, that allow borrowers to take on more leverage and 'grow into' their capital structure – as well as the ability to base financial tests on 'proforma' (rather than 'actual' EBITDA) to comply with covenants, has undeniably increased, Covenant Review indicates that a far greater proportion of European loans cap EBITDA adjustments. Against that, transfer restrictions are notably greater in the European loan market than the US.

This ability to measure the quality of documentation will become increasingly important, in our view, not least as the regulatory requirements on end-investors to have performed adequate due diligence have grown.

Figure 17: Total and first lien leverage

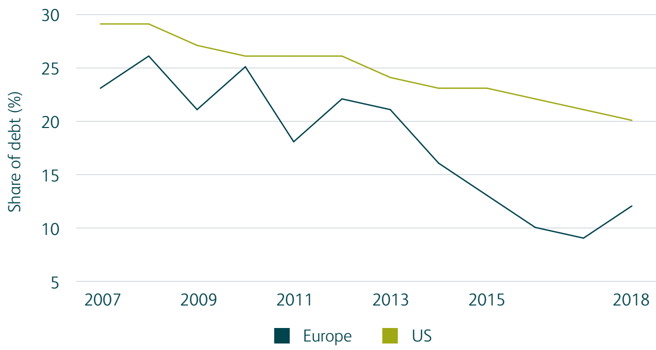


Source: S&P LCD, as at 31 December 2018.

Despite the dilution in investor protections, total new issue leverage has been largely contained in 2019 – at 5.4x as at the end of August 2019 – in line with the US market, according to S&P LCD. The state of leverage in the corporate loan world has come under close scrutiny but the fundamental picture for loans remains supportive. Leverage levels may be expected to remain capped by the leverage lending guidelines set by the ECB and US Regulatory authorities, respectively. It should be acknowledged that there is mounting speculation about the lasting resilience of the US leveraged lending guidelines under the current administration and considering the easing of regulation elsewhere (eg 2018 cessation of 'skin-in-the-game' rules for CLO managers).

A closer look at capital structures reveals that the incidence of all-senior structures has grown, particularly in Europe, while in the US, junior debt makes up a higher proportion of the debt cushion that sits beneath new first lien loans.

Figure 18: Debt cushion of new-issue loans*

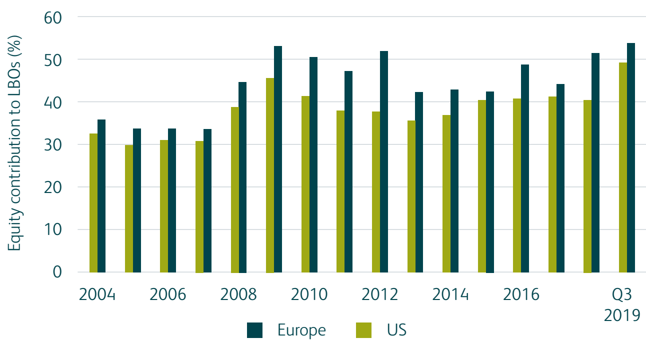


Source: S&P LCD, as at 31 December 2018.
*Reflects share of debt that is subordinated to first lien term loans.

History – in the US at least – has shown that the presence of junior debt in a loan structure will lead to a higher senior debt recovery rate on default, according to S&P, so the prevalence of senior, loan-only structures has raised concern that first lien lenders will be exposed to losses through lower recoveries when the cycle turns. In Europe, things are more complex. Loan restructurings are usually privately-negotiated out of court and it is not always helpful to have another class of debtholder in the discussions even when they have no economic value left. Indeed, in some countries, it can delay the conclusion and optimal outcome of a workout for first lien lenders.

Furthermore, history may not repeat itself in the next downturn owing to higher average equity contributions from sponsors in new loans compared to pre-crisis – 54% in Europe and 49% in the US – providing an additional margin of safety and downside protection for lenders.

Figure 19: Average equity contributions to buyouts



Source: S&P LCD, as at 30 September 2019.

Further considerations for investors

There are additional factors that investors should consider before making an investment in leveraged loans, including access to assets and the need for specialist resources such as dedicated analysts and restructuring expertise for each market.

Access to assets

Europe is a relationship-driven market and therefore requires extensive, dedicated resources for successful long-term investing. It is not uncommon for a loan syndication to be closed early, at the request of the borrower, as a club deal, without general syndication being pursued – which is where having existing relationships can be advantageous. Furthermore, an investor may benefit from remaining 'private-side', assuming its resources can be walled off from its public credit department. The US market, on the other hand, is arguably more public and 'bond-like' in nature with a primary syndication process similar to that for new public bond issues – where the borrower issues an open invitation to lenders to bid for securities.

In the US, managers would tend to benefit from having a larger presence in terms of size (ie total assets) – as the market comprises more large-cap issuers than Europe – and an ability to execute significant volumes of trades in the secondary market. As European loans involve a high degree of operational complexity, including multi-currency features, there are high barriers to entry to new participants. Managers that have established a firm foothold in the market are therefore at a distinct competitive advantage.

Need for dedicated analysts and restructuring expertise

Having long-standing and stable relationships with key market stakeholders (such as private equity sponsors, issuers and banks) can give managers unrivalled access to assets and create an ability to be selective. The onus is on lenders to perform the necessary due diligence as part of a robust (often private-side) credit process to help insulate returns for investors and minimise the risk of default.

In Europe, the crossover between the loan and bond markets is limited. The European market is dominated by private equity-owned issuers, meaning companies that offer no other investment opportunities in any public forum (bonds, equity).

Not only does this arguably mean scope for diversification, but Europe more commonly offers an investor the option to be 'private' rather than 'public', requiring lenders to undertake their own credit analysis. This private-side status affords a lender with valuable information that is not otherwise available in the public domain, permitting fuller credit monitoring.

The need for dedicated analysts and specialists is as integral to the management of distressed situations as it is for day-to-day investment in Europe. Restructurings are usually privately negotiated in Europe, unlike the Chapter 11 route in the US, and can often be complicated and lengthy albeit with similar (high) recovery rates. This feature of European restructurings may become particularly important in the era of cov-lite defaults. In our view, the variability of restructuring outcomes will widen, making the dedication of resources ever more crucial to performance.

ESG

There is now greater awareness of environmental, social and governance (ESG) matters in credit markets, fanned by the preponderance of well-publicised company failures and scandals pertaining to accounting mis-statement or poor disclosure.

This topic is especially important in the European loan market, where companies are typically unlisted and may issue no listed debt securities either. This can present certain challenges for lenders when looking to assess the materiality of various ESG factors, as unlisted companies are not held to the same reporting standards and disclosure requirements of the exchange-traded equity and debt markets. Therefore, trends seen in the public markets to reduce investor disclosure and frequency of reporting should be resisted by lenders. While many investors are choosing to invest and trade loans from the public side to minimise the need for specialist resources, we think that the greater information flow that comes from being private-side is a significant advantage. It is also important in fulfilling one of the UNPRI's principles: active engagement.

Portfolio diversification benefits for loan investors

While investment in European and US loans can offer compelling returns and greater downside protection to an investor, we believe diversification and stock (issuer) selection in a leveraged loan portfolio are essential attributes as leveraged loans present asymmetric risk-return characteristics. It is therefore important that each manager is selective in the investments made to protect a portfolio from default risk, enabled by significant scale and flexibility as well as having good access to assets.

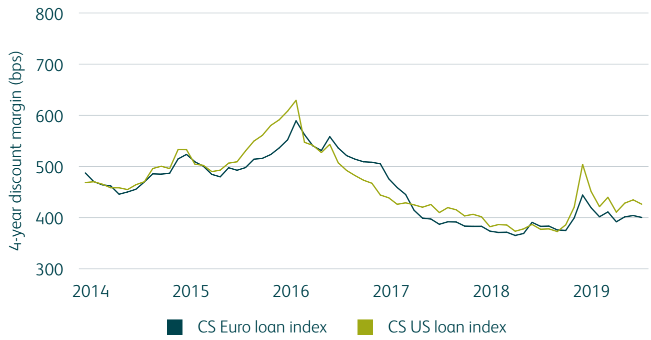
At M&G, it is our aim to provide an investor with exposure to large, stable businesses, including those of truly global presence, while also bringing diversification and liquidity benefits.

Investment conclusions

Structural shifts in the way companies obtain longer-term capital have created an attractive opportunity for large-scale institutional investment in the asset class. There remains significant scope for increased institutional investment in European loans and we believe that it is an attractive time to invest.

The spread premium between the European and US leveraged loan markets has converged, with a mere 26 bps differential at the end of July 2019 (see Figure 20). In our view, there is unlikely to be a notable reallocation of overseas investor capital from European to US loans – while US dollar hedging costs have fallen over recent months, they remain elevated. Furthermore, the performance of European loans typically offers a premium over time and, while liquidity is more limited, it is tolerable by the pension funds and insurance companies that commonly allocate to the market over a cycle.

Figure 20: European and US loan discount margins

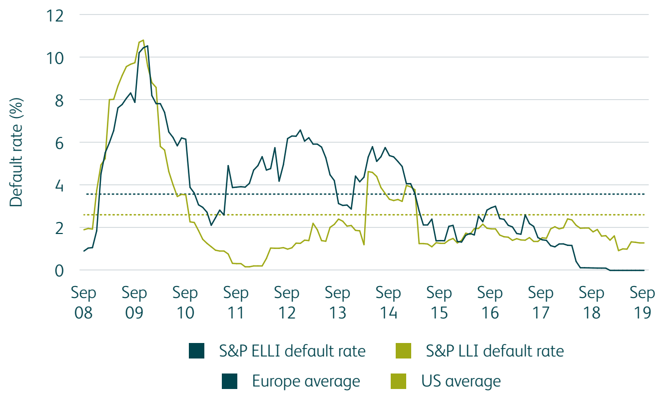


Source: Credit Suisse (CS), as at 31 July 2019.

Companies in the borrowing population are not only larger than that of five years ago, but are often major industry players or best-in-class companies that provide lenders with regular financial reports and other information to attest to their financial health. Loans are also individually rated by managers and often by public agencies too. Selectivity on which loans make it into a portfolio is very important. M&G has declined around 60% of all the deals it has been shown, enabling it to demonstrate a much lower level of defaults than the overall market.

The European loan market's 12-month trailing default rate is currently at zero having fallen to this level at the start of the year while the US market's default rate stood at 1.29%[7]. Default rates are expected to remain subdued and below their historical norms in 2019 but are likely to eventually tick up from the current lows.

Figure 21: European and US loan market trailing 12-month nominal default rates (by value)



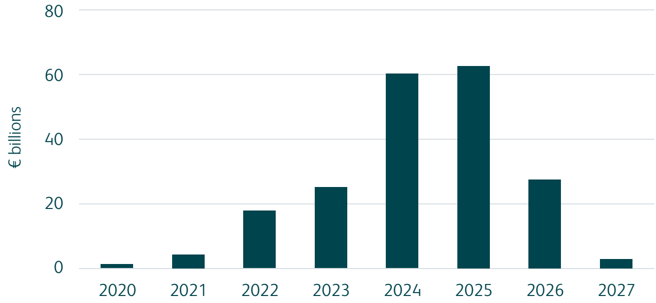
Source: S&P LCD ELLI and LLI, as at 30 September 2019.

[7] Source: S&P LCD, as at 30 September 2019.

The case for low default rates for the foreseeable future is supported by liquidity. Interest coverage ratios remain comfortably high, compared to pre-crisis levels. There is also a lack of refinancing pressure, particularly after the huge wave of refinancing activity in 2017 and the volume of new LBO issuance in 2018. This should stave-off default pressure in the near term.

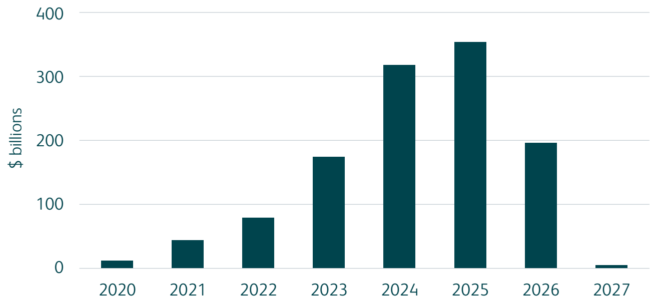
Figure 22: European and US loan markets face minimal refinancing pressure in the near term

European loan market maturity profile



Source: S&P LCD ELLI, as at 31 July 2019.

US loan market maturity profile



Source: S&P LCD LLI, as at 18 October 2019.

Wider markets are likely to continue to take their cue from global monetary policy, macroeconomic and geopolitical news, including the actions of the US Fed and ECB as well as Brexit and ongoing trade tensions between the US and a variety of countries, including China. The shift towards easier monetary policy in the US and Europe has started taking effect in the market, with recent recession worries having put pressure on the major central banks to act.

Given the uncertain backdrop, investors will be looking for stability of returns. While episodes of market volatility cannot be avoided completely, we expect loans to continue to exhibit far greater stability than wider fixed income markets. M&G's view is that a conservative, senior-biased, European-leaning leveraged loan strategy will outperform the market over a cycle.

INVESTMENTS

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